

# THE ECONOMIC SITUATION

## A Quarterly Commentary

**Bruce Yandle**

Distinguished Adjunct Professor of Economics, Mercatus Center at George Mason University,  
Dean Emeritus, College of Business & Behavioral Science, Clemson University

[yandle@bellsouth.net](mailto:yandle@bellsouth.net)

---

**December 2013**

- Prospering, tapering, and prospects for better times.
- What explains the shrinking labor force? Still looking for Waldo.
- Is he in the growing underground economy.
- Are we living in a stationary state?
- Coming to grips with deficits: The fable of the bees.
- Some books for winter reading.

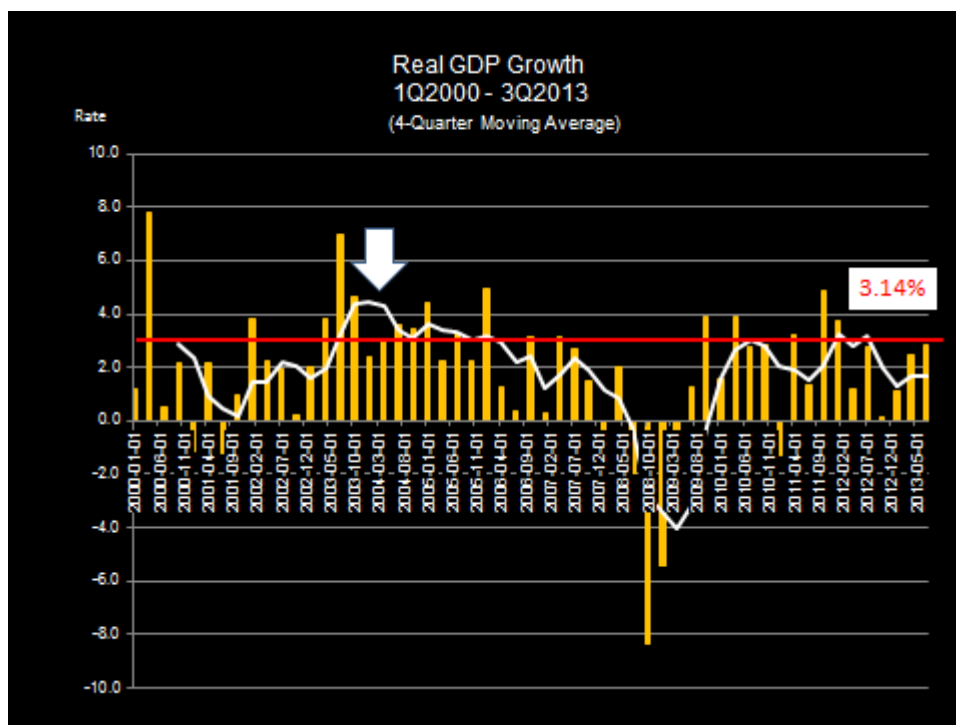
---

### **Prospering and Tapering in a Struggling Economy**

With autumn leaves falling and left-over Halloween jack-o-lanterns still grinning, first estimates for 3Q2013 GDP growth and news of October's employment went bump in the night and rattled the spirits of Washington's chatterbox. GDP growth came in with a "lofty" 2.8% real growth, which was much more than most soothsayers expected. Tapering is on the way! Or so it seemed. The stock market tanked. Then, the Bureau of Labor Statistics announced that 204,000 jobs had been added to the economy in October; this also exceeded analysts' expectations. The market recovered; the economy can handle tapering!

But while 2.8% growth surely looked good, when folded into a 4-quarter moving average, the 2013 economy was still operating well below the 3.14% long-run average pace. Buried in the labor data were numbers indicating most of the growth was in relatively low-paying sectors. But they were jobs!

As indicated in the next chart, GDP's par 3.14% has not been meaningfully exceeded since the early 2000s when the economy was responding to tax cuts, increased spending and accelerated government-sponsored home lending. We know what that witch's brew fomented.



### Digging into the GDP numbers

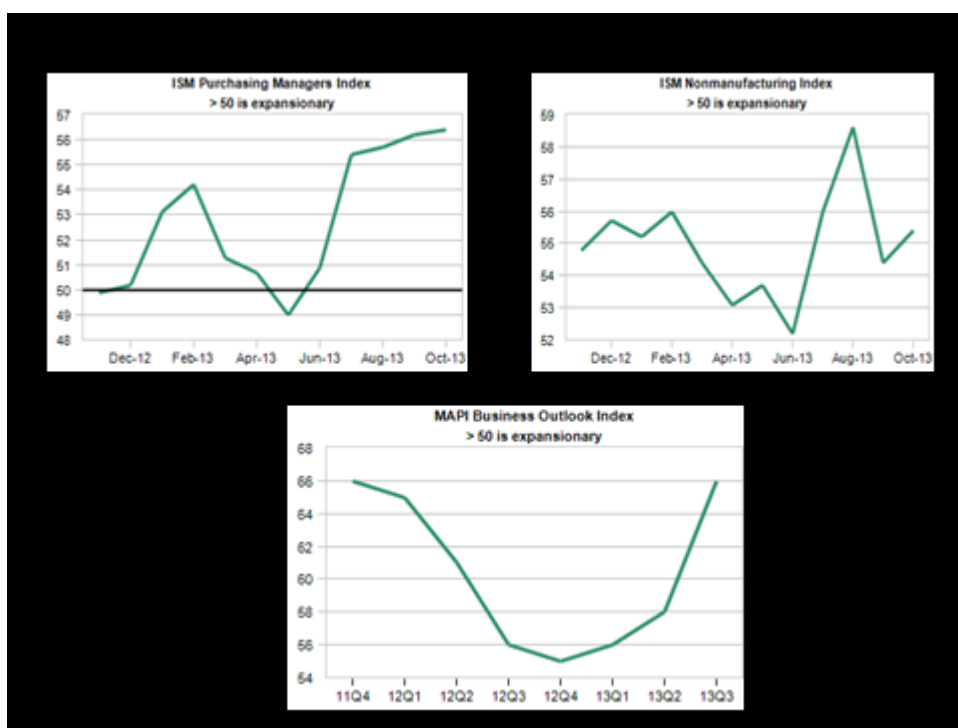
Probing a bit deeper into the GDP analysis, one finds that the higher than expected numbers were associated with lower than expected consumer purchases. This means that about 0.8% of the 2.8% growth came with a run-up in final good inventories—stuff retailers hoped to sell but didn't. This doesn't augur well for 4Q2013 GDP growth, as those retailers may cut their purchases to bring inventories in line with expected sales.

But it's not likely that Black Friday and later holiday shopping will give the economy a shot in the arm. Back-to-school sales, which generally foreshadow December's holiday shopping, were below expectations this year. Big ticket durable goods items purchased partly with low interest debt set a high pace. Retailers offered large discounts to get apparel and lower priced goods off the shelf and out the door. There are always surprises, but fourth quarter performance will likely be well below the 2.8% first estimate for 3Q2013.

## Probing additional data

The stronger than expected job numbers put the effects of the government shutdown under a statistical magnifying glass. The data seem to say the government closing did not hit the economy as hard as some expected. After all, there was full expectation that furloughed workers would be paid later.

There are more data to consider. According to the Institute for Supply Management's monthly monitors, the U.S. economy is clearly accelerating. The recent ISM numbers are well above 50—the neutral point—for both the manufacturing and nonmanufacturing economies. Perhaps more important, the forward looking Manufacturer's Alliance for Productivity Improvement's leading indicator, shown below with the ISM numbers, is pointing north, which predicts higher growth in 2014's second half.



Yet another index, the University of Ohio's Middle Market Indicator, which monitors the activities and expectations of businesses with annual revenues of from \$10 million to \$1 billion and accounting for 7 out of every 10 jobs added this year, is also pointing north, but with a wavering compass needle. The MMI survey reports that these businesses are on track to add 1.25 million jobs in 2013 and that sales revenues for this stalwart group rose 5.5% in the past 12 months, which is twice the pace of the S&P 500 firms.

The wavering needle? The NMI survey reports that hiring expectations for the next 12 months have been reduced in the most recent quarter by some 200,000 jobs. Why? Explanations offered in the survey included fiscal cliff, sequestration, government shutdown, and possible default. Some 47% of the firms surveyed pointed to government uncertainty when identifying reduced hiring plans. It seems the shutdown may have had an effect after all.

So what's the bottom line here? Our slow-growth economy is healing. Better prospects lie ahead. GDP growth over the next 18 months will bounce between 2% and 3%. Interest rates at the long end will rise, perhaps as much as 60 basis points, as the Fed slows the printing presses.

### **The Fed watchers' nightmare**

When stock market indicators rise and fall in conjunction with good news about the real economy, we can rest assured that the response is triggered partly by revised assessments regarding the behavior of the Federal Reserve Board's Open Market Committee. Keeping up with all this forms a Fed-watchers' paradise for some, but a Dante's inferno for others, who, managing assets in a highly uncertain economy, don't get their kicks from Fed watching.

Many remember the now quaint idea that central banks should play a neutral role in the economy, perhaps by increasing the money supply by a fixed amount to accommodate a "normal" rate of GDP growth or that money should be tied to a commodity, such as gold, so that business decision makers and others would focus on producing wealth instead of constantly trying to predict the behavior of a will-o'-the-wisp economy manipulated by the Fed. Along with the idea of predictability was the now almost forgotten notion of Fed independence, that the central bank would not become a pipeline from Treasury for pumping money into the economy, and that it would never become deliberately entangled with politicians plagued by short-run pressures to get up the economy.

Alas and alack, we live in a different world. Discussions of tapering, how and when Fed will act, are routine parts of the evening news, this along with other economic ghouls and goblins that haunt business and family decision makers who seek to create and protect wealth. Fed independence? It takes some doing to imagine how the central bank could be more intertwined with the Treasury than it is today.

While the Fed continues to be a pipeline for pumping new money into the economy, there is no empirical evidence that quantitative easing has directly increased bank lending and resulting economic activity. Instead, there is strong evidence that easing has lifted stock market values while pushing interest rates toward zero. Rising share prices have strengthened consumer balance sheets for those relying on portfolios, and that has spurred increased retail sales, home building, and other important consumer spending. But the anemic interest rates have socked citizens who rely on earnings from savings and insurance

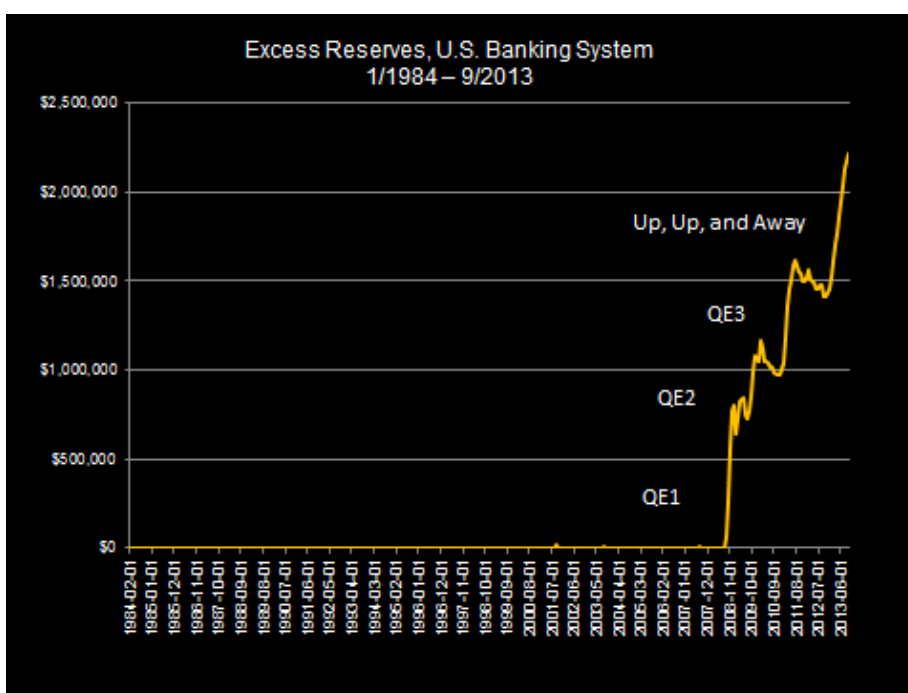
cash value to pay the bills and, in some cases, pushed these thrifty ones to invest in equities. We have a new version of trickle-down economics that penalizes middle income retired folks and rewards Wall Street investors. For now, the high flying market has brought smiles....., for now.

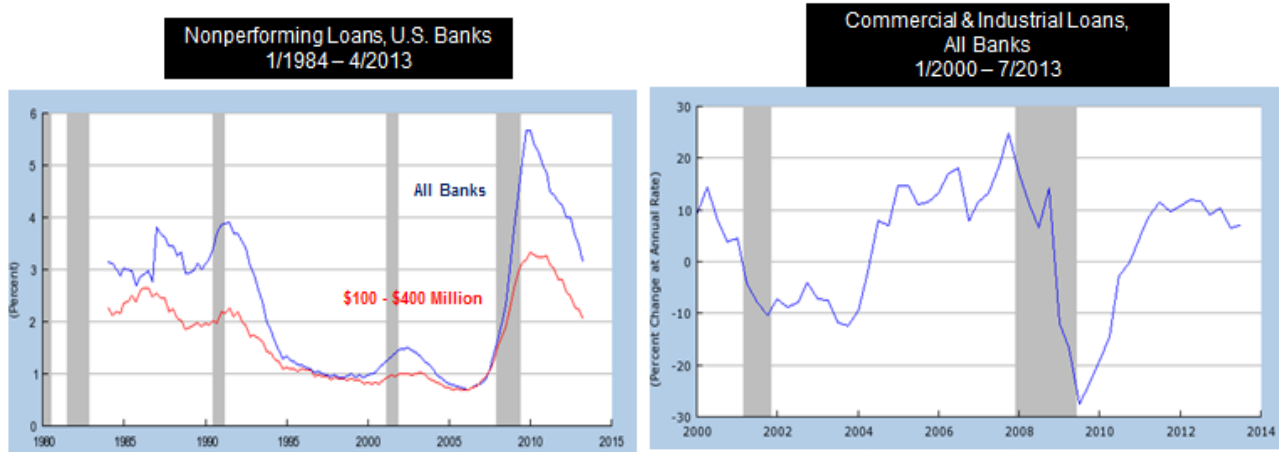
Tapering when it comes, other things equal, will take the edge off equity market advances, just the edge, mind you, reduce fragile consumer confidence, buffet retail sales, and in conjunction with rising interest rates that go with tapering, slow the housing recovery. Fixed income savers will smile again.

### Looking the beast in the eye

The next chart shows the level of excess reserves in the U.S. banking system and identifies the effects of three quantitative easing programs and the current “up, up, and away” Fed activity of injecting \$85 billion into the economy each month. The lesson? When the Fed has purchased mortgage-backed securities from the non-bank public and bonds from Treasury, most of the money inflows have gone into the “vault,” not into new loans.

Why is all that cash sitting on the side lines? First off, bank reserves receive a guaranteed 0.25% return from the Fed. That’s not a lot, but it’s a 100% sure thing with no transaction cost. Then, bank lending is constrained by regulation and remaining weakness in the economy, which takes a toll on the number of credit worthy borrowers who show up in bank lobbies.

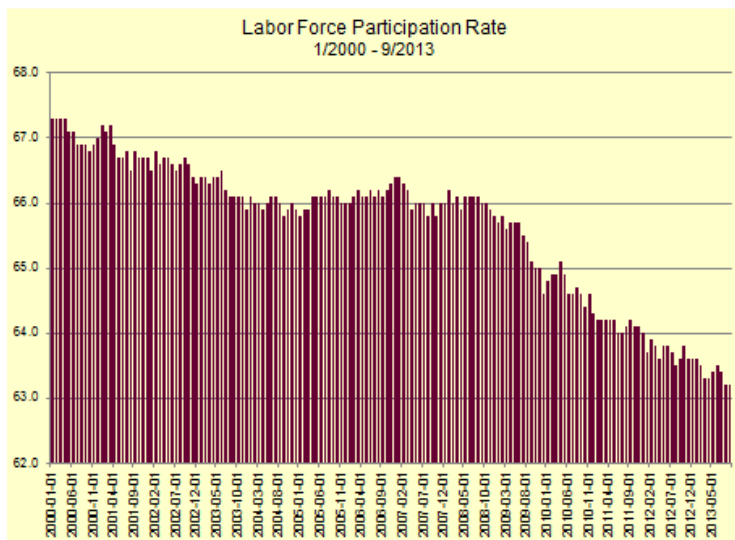




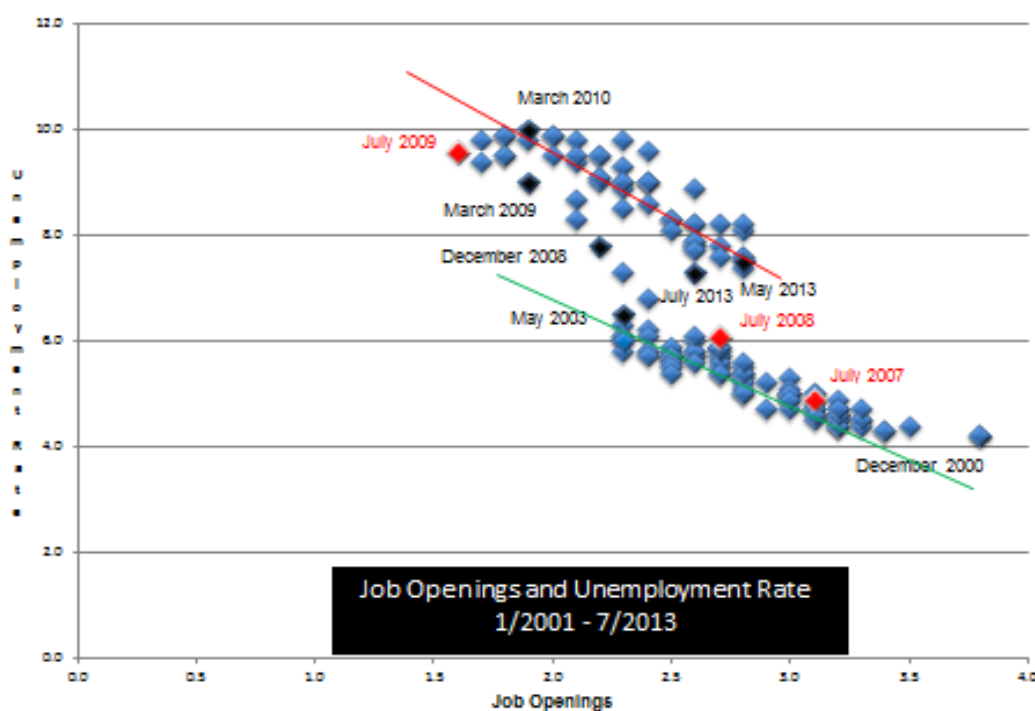
By the way, commercial and industrial loan activity is growing at about 10% annually, with some current weakening. Meanwhile, bank balance sheets are getting stronger. These two charts show what has happened.

### Still Looking for Waldo. Did He Go Underground?

The September Economic Situation report focused on a search for 8.3 million workers who seem to have disappeared from the economy. The topic then was the declining labor participation rate, shown nearby, and how the current low rate translates into 8.3 million missing Waldos.



I am still searching. In the search, I have once again constructed a Beveridge Curve, named for British economist and social reformer, William Beveridge (1869-1983). Beveridge was an early proponent of unemployment insurance. My Beveridge Curve shows a relationship between the unemployment rate and the rate at which jobs are opening in an economy. It is normally expected that unemployment rises when job opening fall. And common sense says that when the rate of job openings increases following a recession, then unemployment rates should go down. The next chart shows the latest, somewhat curious, result.



I say it is curious because of the obvious shift in the architecture of the data as shown by the green and red lines I have placed in the data. Something happened that affected systematically the relationship between job opening and the unemployment rate. This is another way of saying that something happened to the human response to job opportunities that caused jobs to go begging.

I have marked in red July 2007, July 2008, and July 2009. These were dates for minimum wage increases that were set by the Fair Minimum Wage Act of 2007. On July 2007 the minimum moved from \$5.15 to \$5.85. Then on July 2008, the floor moved to \$6.55 an hour. In 2009, the number rose to \$7.25. The first two steps affected some 2% to 3% of the

workforce. The 2009 increase, some 4.9%. The data suggest architecture changed between July 2008 and July 2009.

As Casey Mulligan describes in *The Redistribution Recession*, other Great Recession programs came into play during this time and softened the cost of unemployment and in effect placed a tax on taking a job. Going on a payroll would take away payments for enhanced disability income, extended unemployment compensation, and additional food stamps. Mulligan's empirical work indicates that more than a million workers mustered out of the labor force in association with the higher minimum wage and increased entitlements. The data in my Beveridge Curve support his contention.

I note that Mr. Obama is pushing again for a higher national minimum wage. The data suggest that success in raising the national floor will bring success in keeping the unemployment rate at a higher level. There is an alternative, of course. Some 19 states and the District of Columbia already set minimum wages that exceed the national number.

Instead of painting the entire economic landscape with one minimum wage brush, let federalism work. But having different minimum wage rules in different communities, which might adjust for higher costs of living, does not serve the purpose of raising rivals costs. A higher national minimum imposes no cost on states and cities that already have a high minimum wage. The cost is imposed on those locations that prefer a lower wage structure. And doing that can blunt the competitive edge of producers and people who happen to work and live in low minimum-wage states, which are more likely than not low cost-of-living states as well.

### **Did Waldo go Underground?**

Most people question the notion that people will stop working just to keep \$1,500 a month in Social Security Disability Income. But many others argue that leaving the official labor force doesn't mean leaving work. There is an underground or shadow economy that provides income earning opportunities where people on disability or unemployment compensation, for example, are paid in cash or through barter arrangements.

How big is it? Did it expand with the Great Recession? What do the data show?

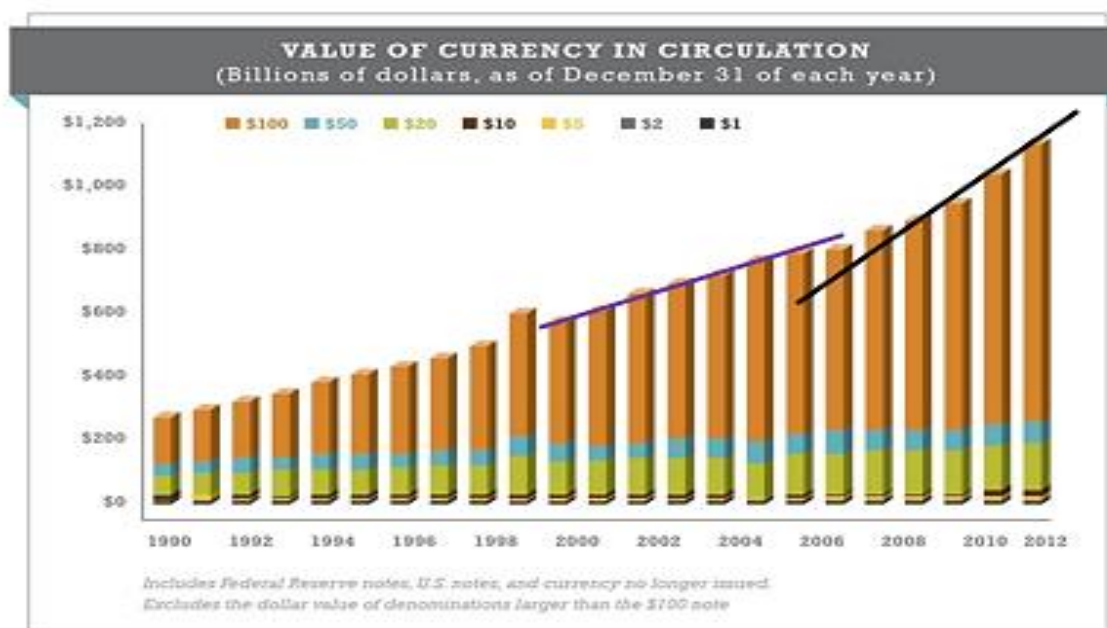
In a 2011 paper, economists Richard Cebula and Edgar Feige sought to size up the underground economy.<sup>1</sup> They did this by focusing on the amount of currency circulating in association with a number of related variables. They found that the underground economy, so measured, expanded rapidly in the Great Recession and now amounts to \$2 trillion in annual output. There is also a corresponding loss of income tax revenues of \$500 billion annually. Just to get a feel for the data, I next show data on the currency in circulation. I

---

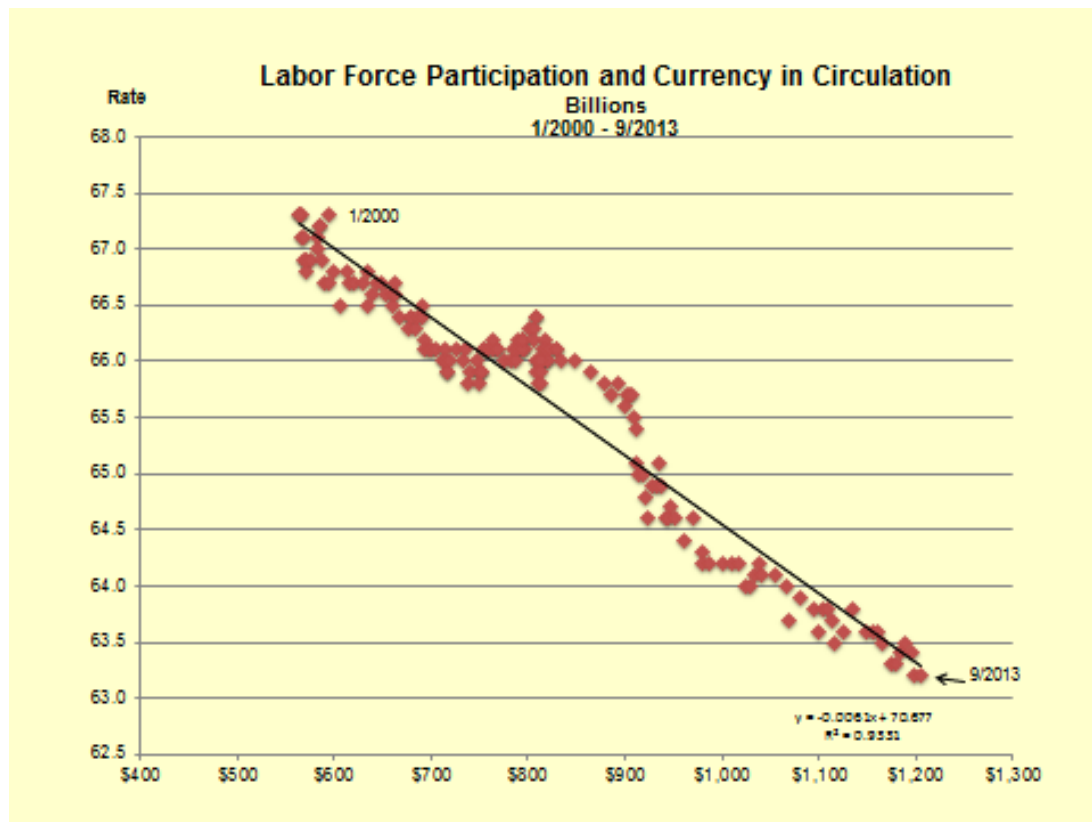
<sup>1</sup> Richard J. Cebula and Edgar L. Feige, "America's unreported economy: measuring the size, growth, and determinants of income tax evasion in the U.S.," *Crime, Law and Social Change*, April, 2012, pp. 265-286.



call attention to \$100 notes, which seem to be mother's milk of underground transactions. I have drawn tangents to the pre- and recession quarters to show how the quantity expanded.

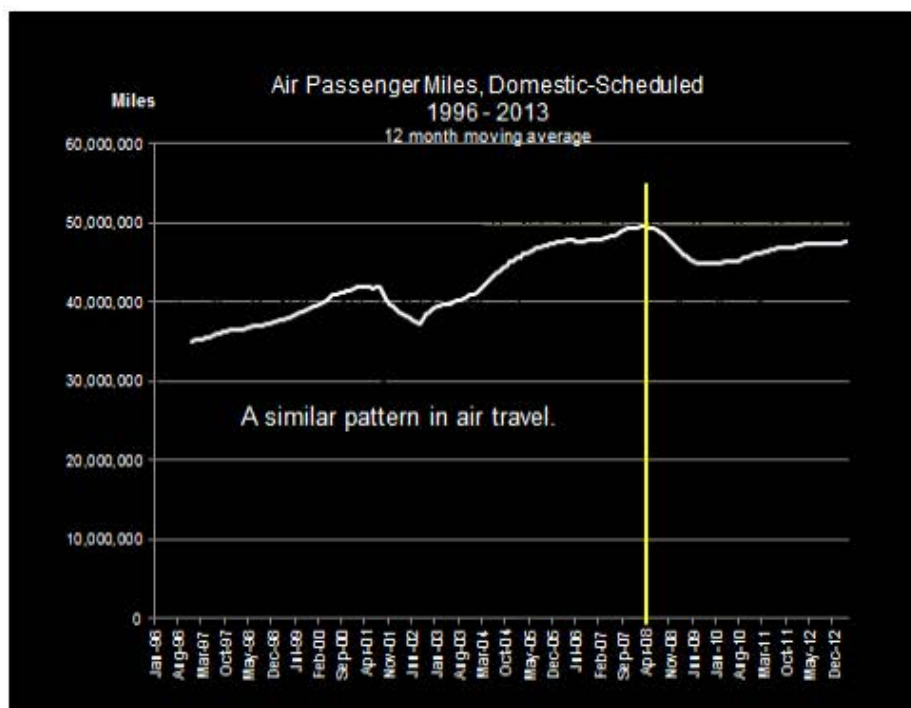
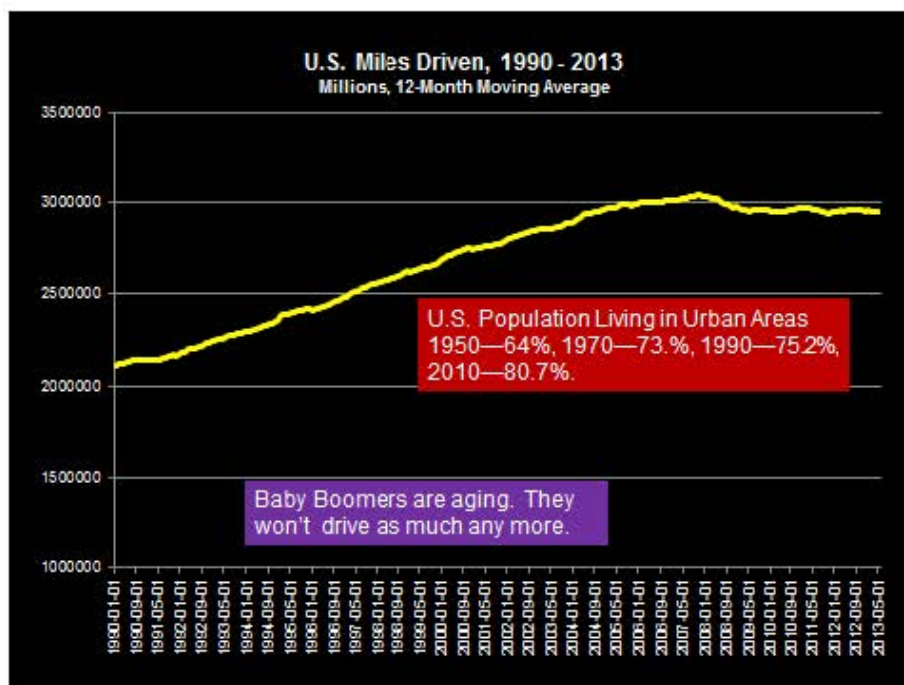


What about the relationship between the labor participation rate and currency in circulation? I show this relationship in the next chart. I include the results for a linear regression. Note how tightly the data fit the line. This direct reading is clear. High levels of circulating currency go with low levels of labor participation. Of course, there is far more to consider. For example, A significant part of U.S. currency circulates in other countries. There are lots of other variables that could affect outcomes, but the simple relationship is pretty strong.

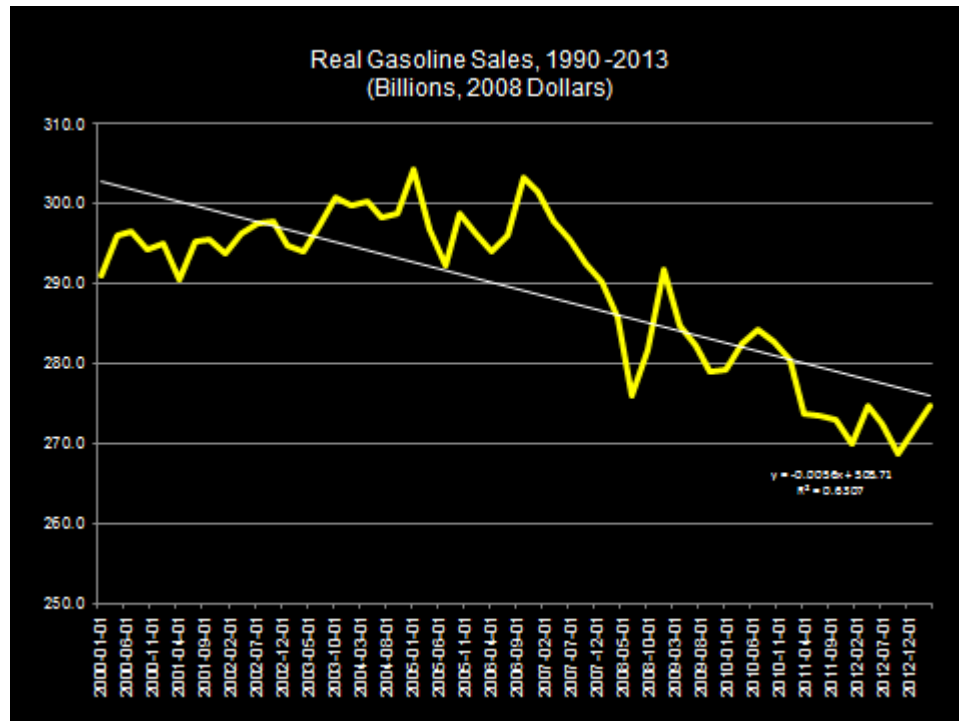


### Are We Living in a Stationary State?

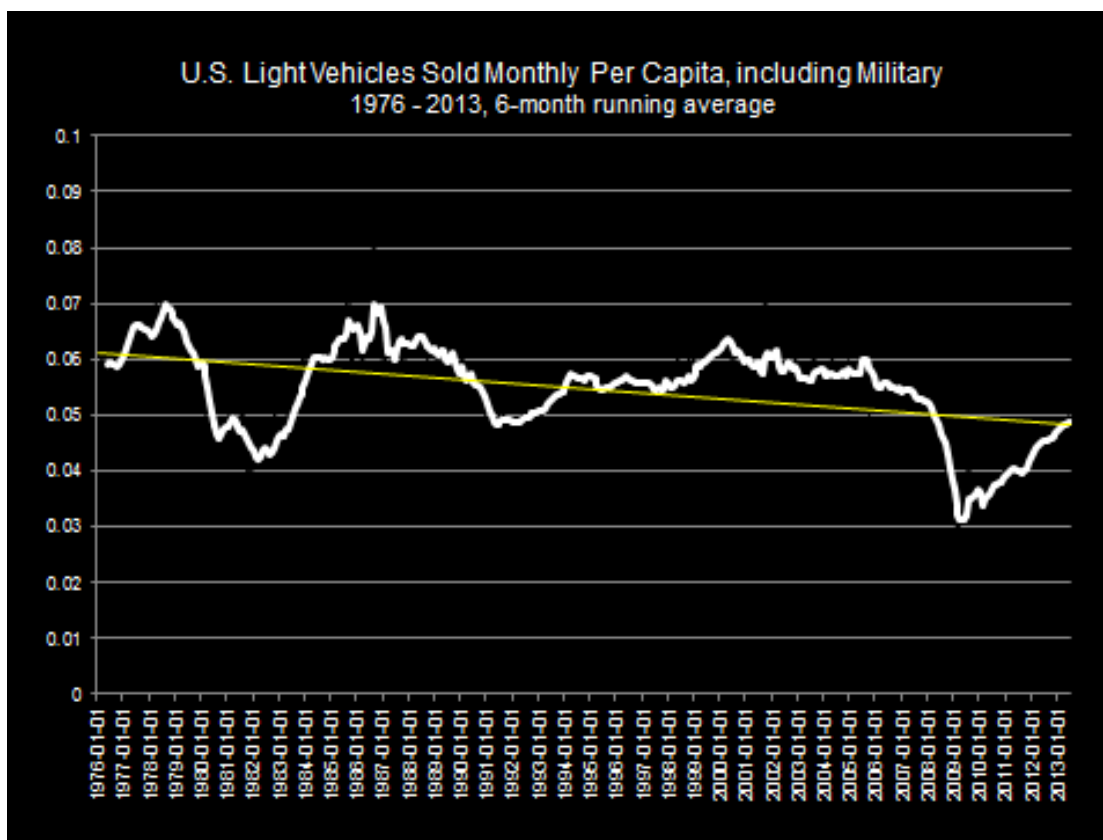
In recent years, the U.S. population has reduced travel in all modes of transportation. For example U.S. miles driven travel by air peaked in 2007 and has been stationary since. At the same time, there is the recession, but also aging baby boomers, who drive less, and more of the population living in cities, where miles driven per capita is low. The data for air passenger miles flown look about the same.



Fewer miles driven combined with a more fuel efficient fleet of cars yields declining gasoline sales. Gasoline sales also peaked around 2007. This presents a serious challenge for state governments that fund highway expenditures with gasoline tax revenues.

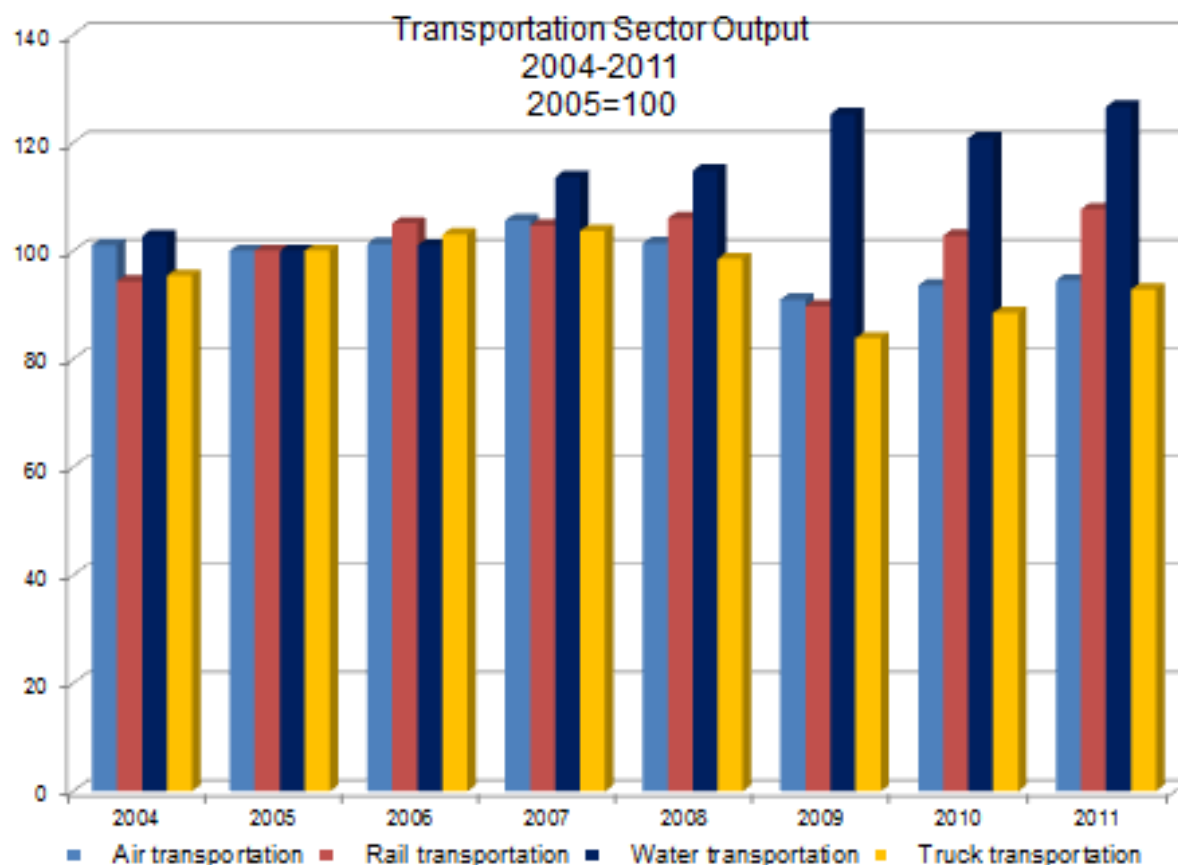


Evidence of the stationary state is also seen in auto sales per capita. The data show a long secular decline.



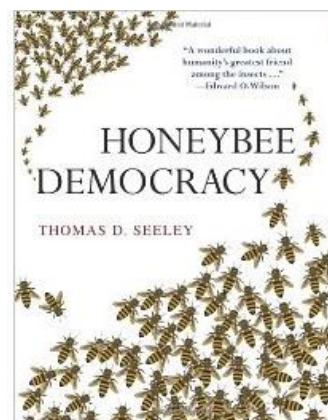
But there is still more evidence of declining mobility. Data on the movement of goods, at least through 2011, tell us that only rail and water transportation modes have more than recovered to 2007 levels. This suggests that shipments of bulk goods—grain, oil, chemicals—are strong, while shipments of smaller lots and packaged goods are weaker. Chances are, we will see recover to pre-recession levels when real GDP growth approaches 3.0% annual growth.

The fact that people are moving less, even with a slow economy, suggests something else is going on, and that may be well be lower cost communications by way of social media. Communications and transportation—talking or viewing versus going and visiting—have always been substitutes. When folded into increased urbanization, we have a more stationary society, at least for now.



## Coming to Grips with Deficits: The Fable of the Bees

Our divided government has once again given itself a few weeks to find agreement for keeping the government open beyond January 15, 2014 and for avoiding debt limit constraints that begin to bite again early in February. The process we are observing is not pretty, but it is the way collective decisions are made in a special interest driven democracy. But while the bickering, name calling, and careful negotiating continues, spending is being cut, the operating deficit is being reduced, and the prospects for entitlement revision—the real crux of the budget problem—are brightening.



Our situation is almost identical to the problem faced by colonies of bees that due to population growth find that their current hive is inadequate. With the queen no longer able

to pollinate, they need a larger kingdom, which means moving to another location. Biologists who study this problem have noted for years that bees swarm in search of a new location, and that they consider competing proposals, form caucuses, and vote. They do not move until a consensus of support emerges for the next location. (For those interested in knowing about this, try Thomas Seeley's *Honeybee Democracy*.)

But so far as we know, bees do not form narrow special interest groups that are able to transfer wealth from the hive to themselves by way of extending debate about the next location. Of course, members of congress can do that for those in their states and districts that keep them in office. Each temporary government shutdown postponement provides another crisis opportunity and a chance to load special interest pork into the next legislative fix that temporarily reopens government. The more grave the crisis, as communicated by breathless media commenters and downcast politicians, the less likely rank and file voters will search out the special interest deals buried in the salvation legislation.

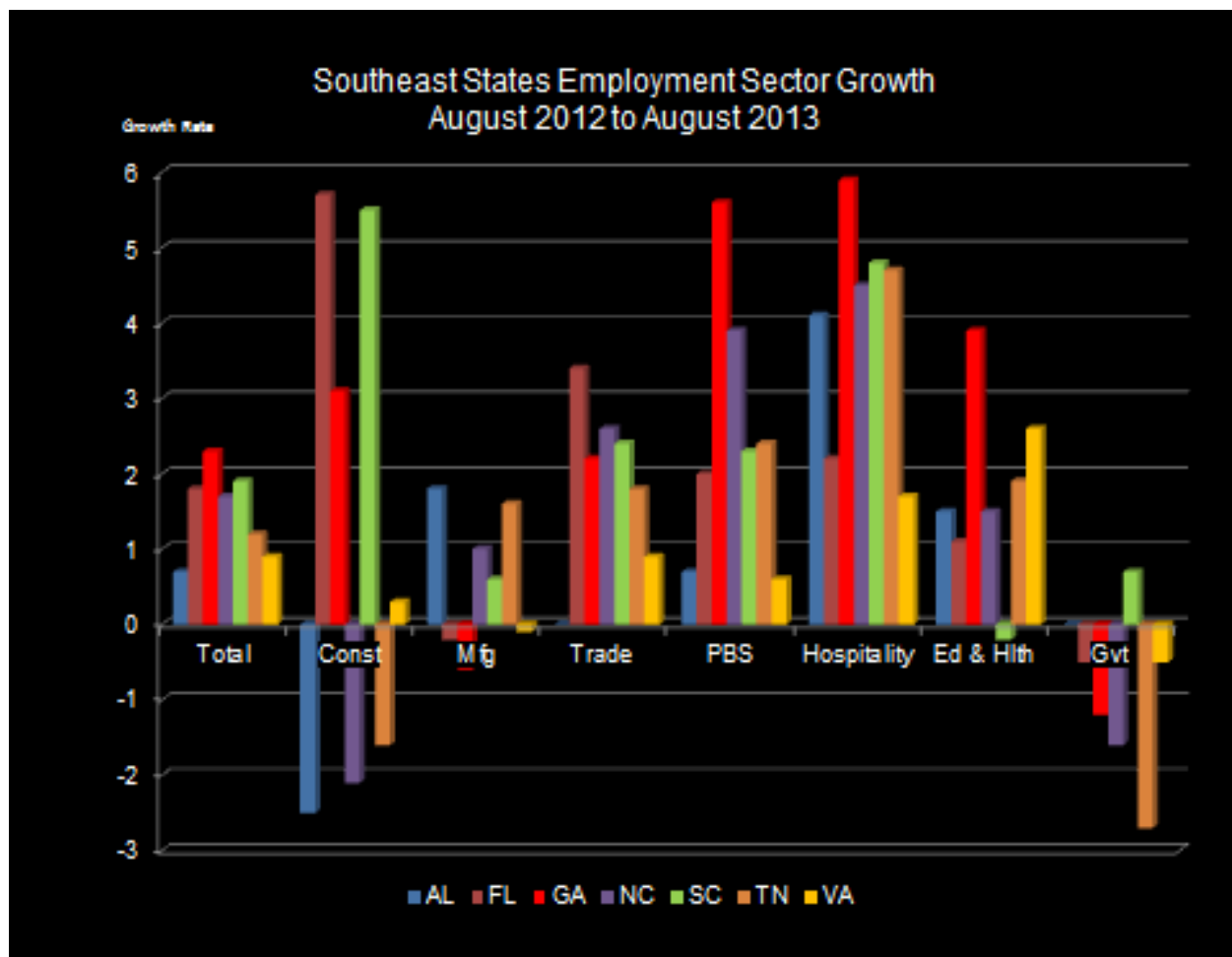
The Public Choice interpretation I have just offered brings with it a forecast. It goes as follows: Congress will be prone to extend a series of continuing resolutions on the way to fixing the deficit and debt limit problem and will always wait till the last minute when doing so. But Congress will only by miscalculation diddle to the point of creating default. There is no interest group gain from this.

Eventually, though, like bees that seem a bit brighter than their human keepers, politicians will, through a series of repairs, reach the point of approving a fiscal year budget, one that will bring meaningful reductions in entitlement spending and deficits.

But that moment is likely to be years away.

## **Taking a Peak at the Southeastern United States**

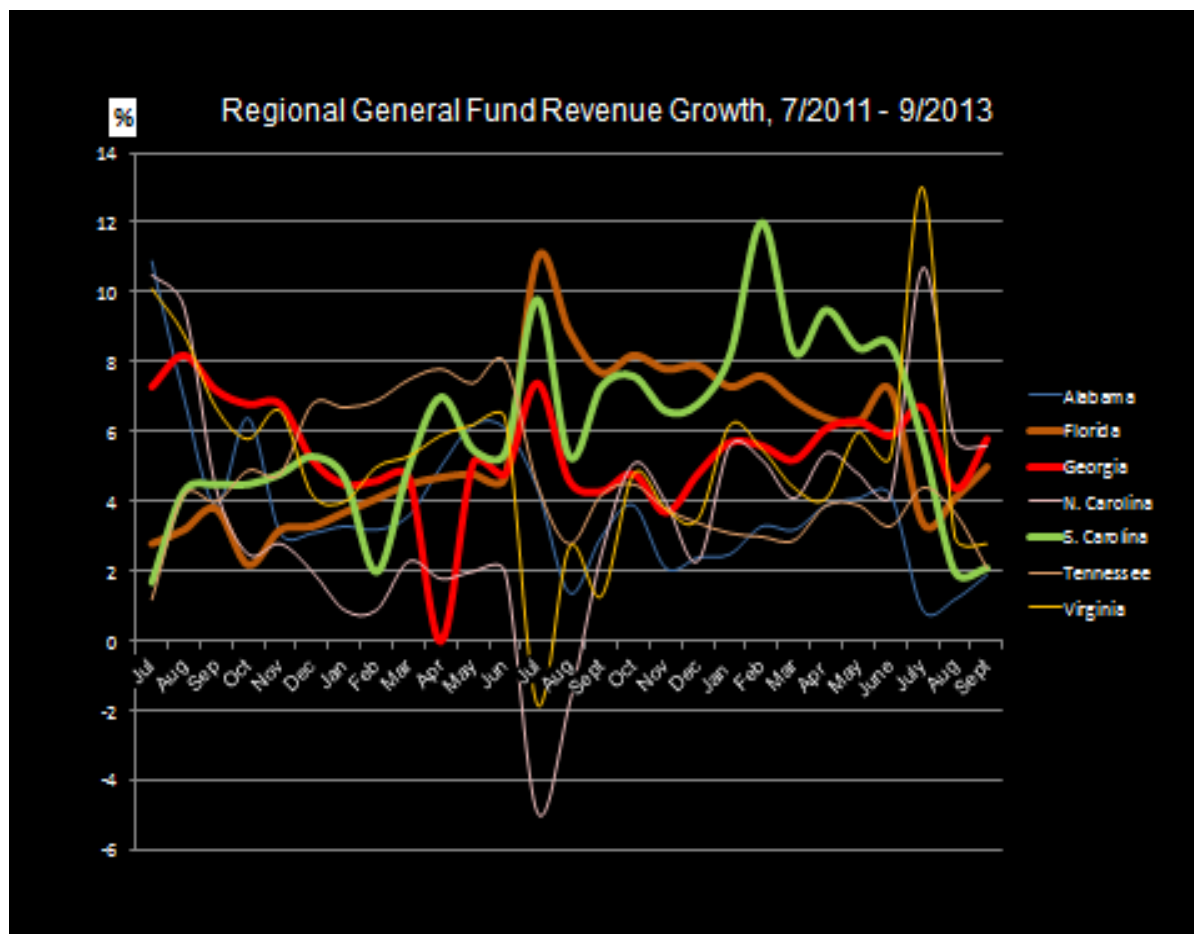
Across the United States, there are pockets of prosperity and districts of despair. State unemployment rates for August 2013 ran from North Dakota's low of 3% to Nevada's 9.5%. The variation is far greater across counties and metro areas, even in the same state. In this section, I offer a couple of data snapshots of southeastern states. The next chart shows employment growth by sector for the most recent 12-month period. On total employment growth for states, Georgia ranks first and South Carolina second. Georgia's strong sector growth is noteworthy as is Alabama's weaker growth. Florida and South Carolina show booming construction activity



Manufacturing is obviously not where employment growth is being registered. But all but Virginia are showing a strong hospitality industry. The industry's employment is generally associated with relatively low wages. Professional Business Services (PBS) is a key sector to consider. It is a higher wage sector, and the knowledge economy is hooked to this sector.

I next report data on state general fund revenues for the same states. To some degree, of course, the tax revenue data map into the employment growth data. I have used a heavier line for Florida, Georgia, and South Carolina because of their relative strength. South Carolina has been pacing the other states until most recently. Now, it seems Georgia's and Florida's growth rates are pointing north.





### Some Winter Reading Suggestions

There are two very different books to consider adding to the winter reading list. For sheer reading pleasure, especially for car nuts, consider Bob Lutz's, former General Motors co-chairman and chief among car nuts, 2013 offering *Icons and Idiots*. Highly entertaining and informative, Lutz focuses on leadership and does this by giving a chapter-by-chapter offering on leaders he has known across his life experience. These run the gamut from an inspiring high school teacher, a Marine drill instructor, to the presidents of BMW, Chrysler, and General Motors. Lutz pulls no punches as he identifies strengths and weaknesses, but he always ends with an on-balance positive statement about the individual, even if he failed the leadership test. Lutz quantifies leadership traits for each person discussed and tells how he did this in an interesting appendix.

For those who want a relatively heavy economics book, I recommend Casey Mulligan's 2012 *The Redistribution Recession*. Mulligan, a much celebrated University of Chicago faculty member, applies price theory with a vengeance, but in a very readable fashion, as he explains how expansions of entitlements and increases in minimum wages encouraged American workers to leave the labor force. Mulligan points out that means tested benefit

programs that expanded just before and during the Great Recession helped many to weather the recession's storms but also sharpened incentives to stay on welfare. Mulligan refers to this effect as a tax on work. He quantifies the effect of all this and shows how millions departed the workforce and have not returned. His most recent analysis of Obamacare points out that the program's significant income-based subsidy for some will give an incentive for those in higher subsidy brackets to avoid crossing the income line that substantially increases healthcare cost—another tax on work.

## **A Snapshot of the Coming Year**

I close this report with a summary of my current expectations for the year ahead.

### **2013-14 U.S. Outlook**

#### **The Nation**

- Quarterly GDP growth will range from 2.0% to 3.0% across 2013 and 2014.
- Wealth is being created. Retail sales are recovered and rising. Housing is recovering.
- The unemployment rate will stay in the 6.5% to 7.5% range.
- Inflation will range 1.5%-2.0%.
- Interest rates will be rise as the Fed gently tapers. 20-year bond, recently 3.72% before falling again, will hit 4.10%.
- Energy prices will remain flat, if not lower.

#### **Hazards or ghosts from the past that may disturb the outlook.**

- If rapid, Fed unwinding of massive excess reserve position poses serious risk for interest rate run-up and decline in equity prices, which will in turn produce negative wealth effects.
- A huge deficit that must be dealt with. Taxes? Cut spending? Print money?

